

OFFICE OF LEGISLATIVE OVERSIGHT REPORT 2011-2

**Achieving a Structurally Balanced Budget in
Montgomery County**

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Web Address for Parts I & II of the Report:
<http://www.montgomerycountymd.gov/olo>
(Select: "Reports and Memorandums" then select: "Reports completed since 2001")

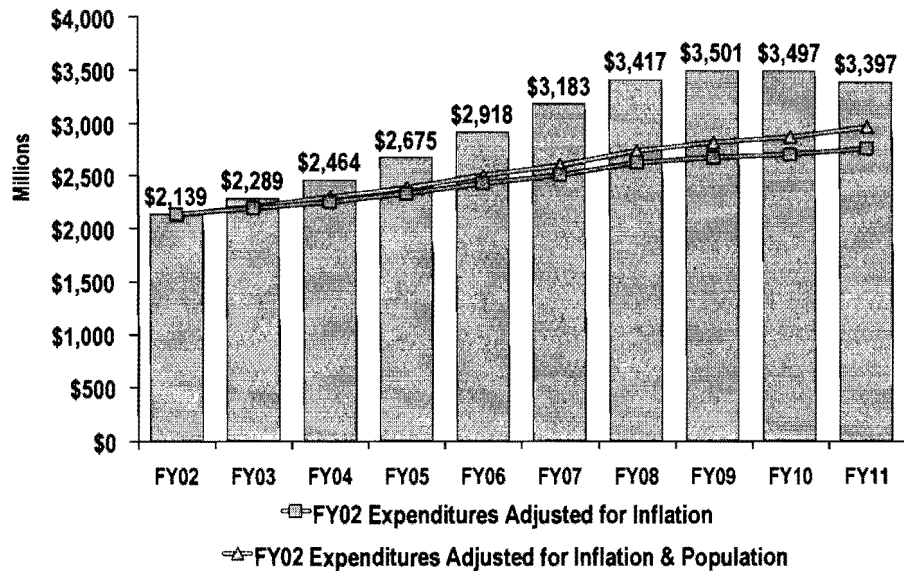
Office of Legislative Oversight Report 2011-2

Achieving a Structurally Balanced Budget in Montgomery County

1a

Tax Supported Expenditures

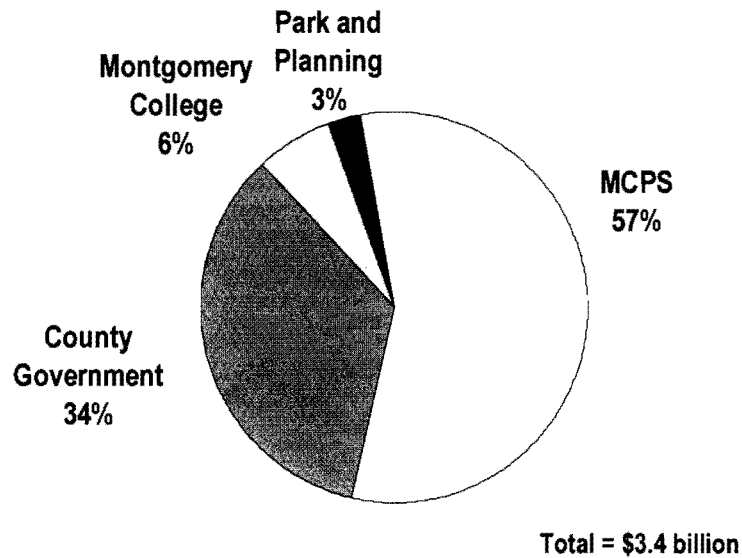
Increased 59% between FY02-FY11



1b

FY11 Tax Supported Operating Budgets

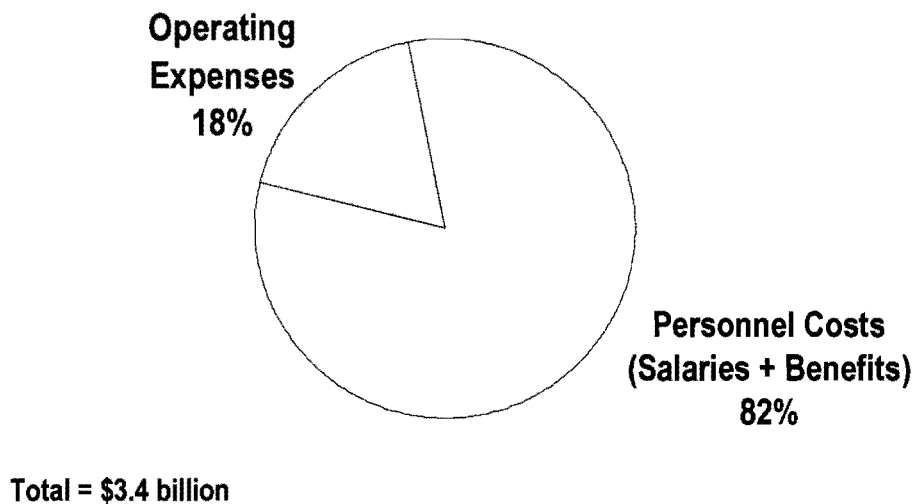
MCPS and County Gov't account for 91% of all spending



2a

FY11 Approved Tax Supported Operating Budgets

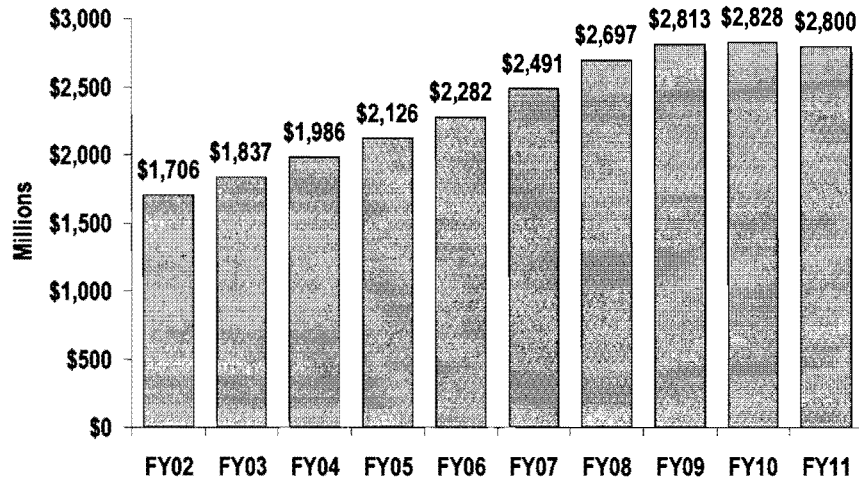
Personnel costs account for 82% of spending



2b

Tax Supported Personnel Costs

Increased 64% from FY02-FY11



3a

Tax Supported Workyears

	FY02	FY11	Percent Change
All Agencies	26,702	29,400	+10%
MCPS	17,085	19,439	+ 14%
County Government	7,347	7,374	+ 0.4%
Montgomery College	1,363	1,773	+30%
Park & Planning	907	814	- 10%

3b

Average Annual Salary Adjustments

		County Gov't	MCPS
FY07	GWA	3.7%	3.5%
	Step	3.5%	3.5%
FY08	GWA	4.8%	4.6%
	Step	3.5%	3.5%
FY09	GWA	4.1%	5.0%
	Step	3.5%	3.5%
FY10	GWA	None	None
	Step	3.5%	3.5%
FY11	GWA	None	None
	Step	None	None

4a

County Government Tax Supported Benefit Costs

	FY02	FY11	% Change
Active Employee			
Social Security	\$28m	\$40m	+43%
Group Insurance	\$36m	\$80m	+120%
Retirement	\$42m	\$117m	+181%
Retiree Group Insurance*	\$13m	\$31m	+131%
Total Benefits	\$119m	\$268m	125%

4b

* Annual pay-as-you-go contribution only; no retiree group insurance trust fund (OPEB) contribution made in FY11.

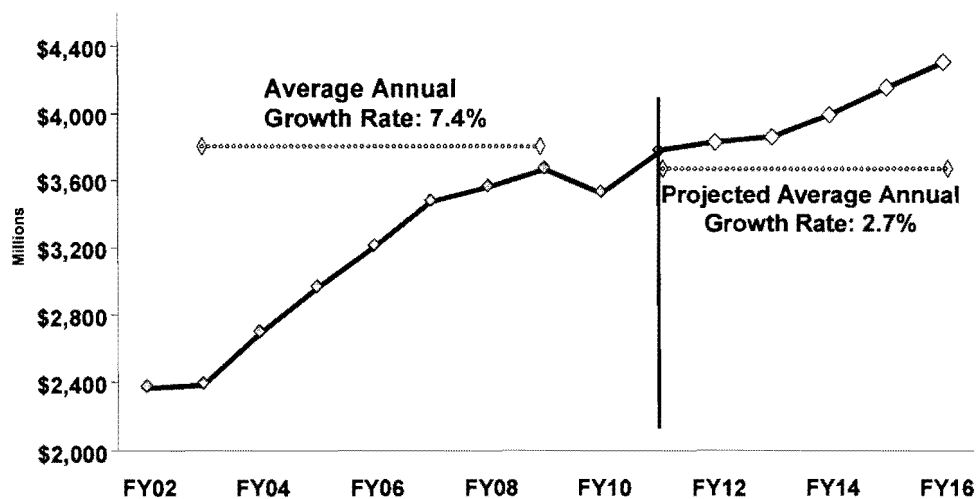
MCPS Tax Supported Benefit Costs

	FY02	FY11	% Change
Active Employee			
Social Security	\$66m	\$99m	+51%
Group Insurance	\$87m	\$216m	+147%
Local Retirement Contribution	\$16m	\$62m	+287%
Retiree Group Insurance*	\$14m	\$43m	+198%
Total Local Benefits	\$183m	\$420m	+130%
State Pension Contribution	\$63m	\$170m	+168%

* Annual pay-as-you-go contribution only; no retiree group insurance trust fund (OPEB) contribution made in FY11.

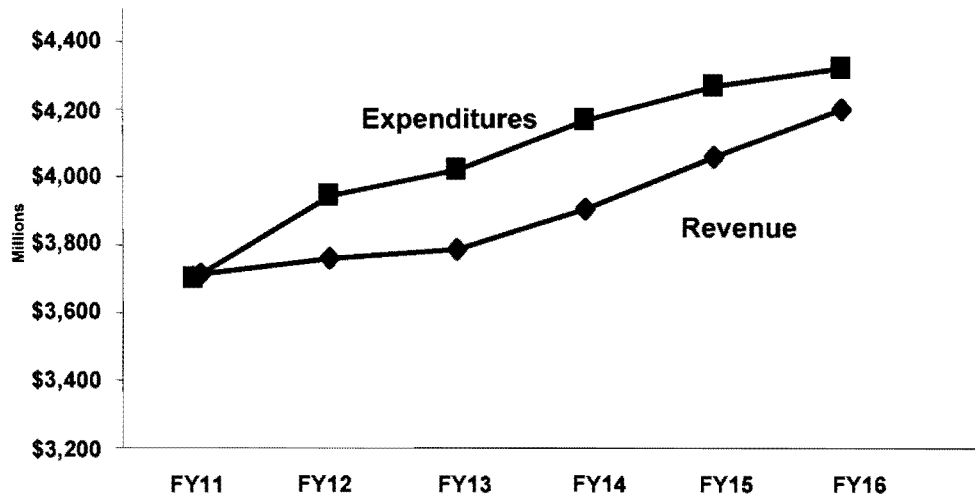
5a

County Tax Supported Revenues Past and Projected (as of December 14, 2010)



5b

Projected County Tax Supported Revenues and Expenditures



6a

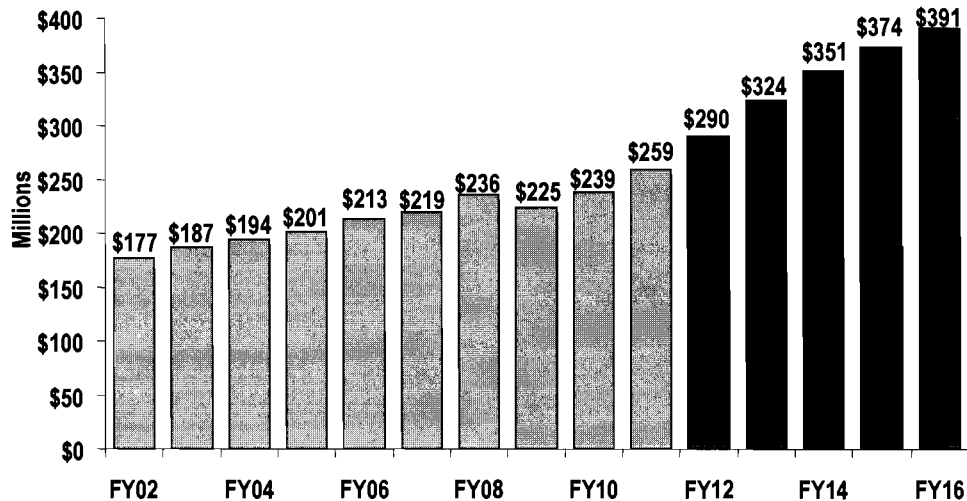
Employee/Retiree Benefits

	<u>FY11 Budgeted</u>	<u>FY16 Projected</u>
Retirement plans	\$193 million	\$264 million
Employee health insurance	\$315 million	\$487 million
Retiree health insurance	<u>\$77 million</u>	<u>\$124 million</u>
	\$585 million	\$875 million

6b

 Potential transfer of teacher pension costs
 from State to County
 (\$50 - \$100 million per year)

Annual Debt Service, FY02-FY16



7a

Fiscal Policies

- Structurally Balanced Budget
- Fund Reserves
- Use of One-Time Revenues
- Priority on Unfunded Liabilities
- Current Revenue for Capital Projects

7b

Options for Long-Term Fiscal Balance

8a

What Guided OLO's Selection of Options

- **Experience of other jurisdictions**
- **Advice of subject matter experts**
- **Potential for substantial and recurring savings**
- **Legal feasibility**

8b

What Guided OLO's Selection of Options

(continued)

- **Reduce per employee costs**
- **Supplement concurrent efforts**
- **Role of debt service**
- **Revenue alternatives**

9a

Issue Papers

- A. Employee Salaries**
- B. Retirement/Pension Benefits**
- C. Health Benefits for Active Employees**
- D. Health Benefits for Retired Employees**
- E. Workforce Size**
- F. Operating Expenses**
- G. Debt Service**
- H. Revenue**

9b

Employee Salaries

Option: Salary rollback in FY12

Amount	Estimated FY12 Savings
1% Salary Rollback	\$22.9 million
3% Salary Rollback	\$68.7 million
5% Salary Rollback	\$114.6 million

10a

Health Benefits for Active Employees

Option: Change to 70/30 cost share

Implementation Model	Estimated FY12 Savings
Change to a 70/30 split, All-at-once	\$35.2 million
Change to a 70/30 split, 5% phase-in	\$9.7 million

10b

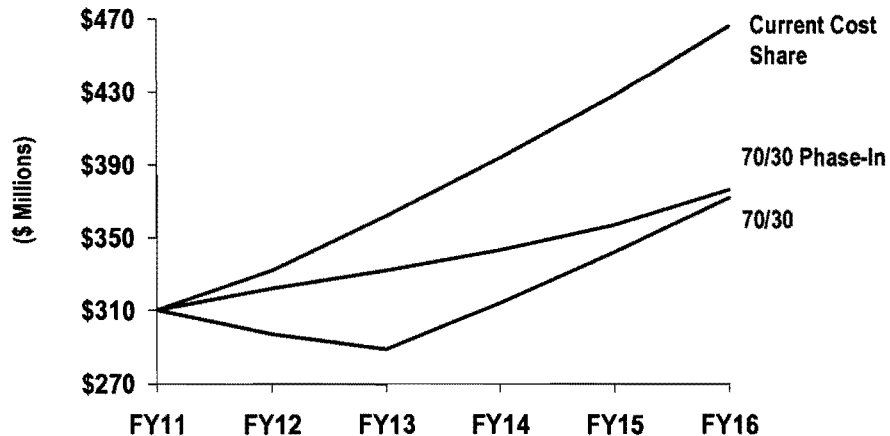
2011 Premium Cost Share

(Medical and Prescription Drug)

	Agency	Employee
<i>MCPS</i>		
HMO Medical	95%	5%
POS Medical & Prescription Drug	90%	10%
<i>County Government</i>		
Choice – Full/Part Time	80%	20%
Select – Full Time	76%	24%
<i>M-NCPPC</i>		
Employees and Appointed Officials	85%	15%
<i>Montgomery College</i>		
Full-time Staff and Faculty	75%	25%

11a

Agency Health Benefit Costs



11b

Retirement/Pension

- **Defined Benefit Plan**
 - Pension plan
- **Defined Contribution Plan**
 - Similar to 401(k)
- **Majority (~88%) of agency employees in defined benefit plans**

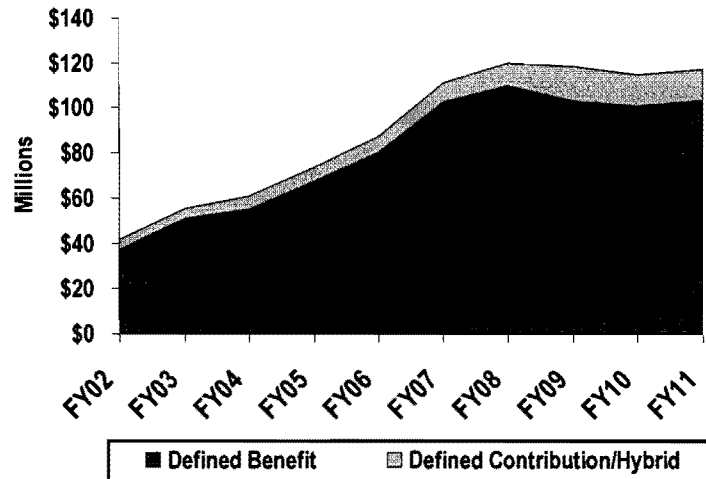
12a

Retirement/Pension Benefits

Option: Enroll all new County Government employees in a defined contribution plan

12b

County Government Budgeted Retirement Contributions, FY02 – FY11



13a

Workforce Size

Agency	Average Cost (salaries + benefits) per Workyear	# of Workyears Equal to \$10 Million in Personnel Costs
County Government		
Public Safety Workyear	\$112,900	89 workyears
Non-Public Safety Workyear	\$91,700	109 workyears
MCPS		
Agency Average Workyear	\$87,800	114 workyears
Teacher "New Hire" Workyear	\$65,200	153 workyears
M-NCPPC		
Agency Average Workyear	\$84,000	119 workyears
Montgomery College		
Agency Average Workyear	\$79,000	127 workyears

13b

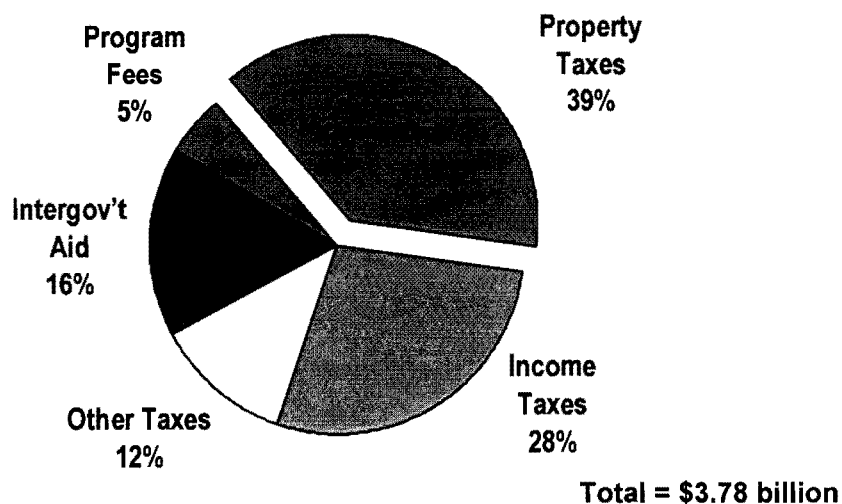
Examples of What \$10 Million in Workyears Represents

\$10 Million in Personnel Costs Pays for.....	Which Represents.....
County Government 89 Public Safety Workyears	• 100% of career firefighters assigned to the following stations combined: Silver Spring #1, Kensington #18, and Gaithersburg #28
MCPS 153 Teacher "New Hire" Workyears	• 85% of elementary school music teachers
Montgomery College 127 Agency Average Workyears	• 25% of all Instructional Faculty across all three campuses
M-NCPPC 119 Agency Average Workyears	• 83% of all Planning Department Staff

14a

Revenue

FY11 Tax Supported Revenue by Source



14b

EXECUTIVE SUMMARY
PART I, REVENUE AND EXPENDITURE TRENDS IN MONTGOMERY COUNTY

At the request of the Montgomery County Council, the Office of Legislative Oversight examined the tax supported revenue and spending trends over the past ten years and projected for the next six years. The purpose of the review, which included Montgomery County Government, Montgomery County Public Schools, Montgomery College, and the Maryland-National Capital Park and Planning Commission, was to:

- Quantify patterns of revenue and spending, and analyze how agency budget growth compared to changes in factors such as inflation and population, and increases in school enrollment.
- Identify past and emerging “cost drivers,” and improve understanding of how previous decisions regarding revenue and spending affect current and future budgets.
- Compile data on the County’s spending “commitments,” defined as items that the County is obligated by law and/or policy to fund; these commitments include debt service, health insurance for active and retired employees, pension plan payments, and contributions to the County’s fund reserves.
- Based on the revenue assumptions contained in the most-recently adopted Fiscal Plan, describe the parameters of the County’s future challenge to achieve a structurally balanced budget.

A. THE STRUCTURAL BUDGET CHALLENGE DEFINED

The cost pressures and difficult trade-offs facing Montgomery County are by no means unique. Vigorous debates are taking place across the country about how to recover from the most serious recession since the Great Depression. With few exceptions, state and local governments are grappling with how to address fiscal projections that show a massive imbalance between expected revenues and desired expenditures.

The imbalance today between projected revenues and desired expenditures in Montgomery County, similar to the imbalance in other places, contains both cyclical and structural components. A “cyclical budget gap” is a short-term imbalance between projected revenues and desired expenditures that reflects the ups and downs of the business cycle. In contrast, a “structural budget gap” exists when projections of expenditures exceed projections of ongoing revenues on a persistent and recurring basis. The distinction between the two is that a structural budget gap continues to exist even when revenue growth resumes.

A common ingredient of the budget challenge facing jurisdictions across the country is the increasing portion of tax supported budgets that must be allocated to fixed spending commitments. In Montgomery County, these commitments include debt service, health insurance for active and retired employees, pension plan payments, current revenue contributions to the capital budget (PAYGO), and contributions to the County’s fund reserves. A structural budget problem becomes increasingly evident when the projected cost increases of a government’s commitments exceed its projected revenue growth. This is precisely the situation facing Montgomery County for the foreseeable future.

The traditional scenario for making annual budget decisions no longer works when a jurisdiction faces a structural budget problem. Under the traditional scenario, projected revenue for the upcoming fiscal year is sufficient to: fully fund the current year’s budget (again), absorb growth in the cost of commitments, and pay for new initiatives, such as program expansions and pay increases for employees. In the current climate, revenue growth for the foreseeable future is unlikely to keep pace with the steadily rising costs of the public sector’s spending commitments. **Montgomery County, like many other governments, now faces the extraordinary challenge of bringing projected revenues and spending into alignment, which can only be accomplished by raising more revenue or making reforms that bend the future cost curves downward.**

EXECUTIVE SUMMARY
PART I, REVENUE AND EXPENDITURE TRENDS IN MONTGOMERY COUNTY

B. OVERVIEW OF REVENUE AND SPENDING FY02-FY11

1. **From FY02 to FY11, the tax supported agency budgets in Montgomery County collectively increased 59% from \$2.1 billion to \$3.4 billion.** The macro-cost curve shows annual increases of 7-9% between FY02 and FY08. Total tax supported spending leveled off in FY09 and posted actual declines in FY10 and FY11. During the same ten year period, inflation was 29%, the County's population grew 12%, median household income increased 21%, and the County's assessable property tax base increased 114%.
2. **The County's increased budgets supported some notable expansions in agency services, including:**

<u>Montgomery County Public Schools</u> <ul style="list-style-type: none">• Reduction in class size• Expansion of full-day Kindergarten• Enhanced staff development programs	<u>Montgomery College</u> <ul style="list-style-type: none">• Expanded services to meet 32% enrollment increase• Opening of new facilities
<u>County Government</u> <ul style="list-style-type: none">• Additional public safety personnel• Expanded Ride-On service hours• More resources for health & housing programs	<u>M-NCPPC (Montgomery County portion)</u> <ul style="list-style-type: none">• 12% increase in park land• Creation of the Legacy Open Space Program
3. **The County's budget growth was funded by a combination of more property tax revenue, higher income and excise tax rates, and substantial growth in State aid (mostly to MCPS).** Over the ten years, revenue growth in the County outpaced inflation and population increases by about 20%. The ten year average annual revenue growth rate of 6% (FY02-FY11) is twice the forecast for the next six years, which is for an average annual growth rate of 3%.
4. **In FY11, MCPS received 57% of total tax supported agency allocations and County Government received 34%; the balance went to Montgomery College (6%) and M-NCPPC (3%).** The allocation among the four tax supported agencies remained largely unchanged during the past decade, although how money is spent within each agency evidenced some shifts. Notable trends included a higher portion of agency budgets spent on employee benefits and a higher portion of County Government resources dedicated to public safety services.
5. **Conceptually, debt service can be considered a fifth agency because it must be paid from the same pot of tax supported dollars.** During the past decade, debt service payments increased 47% from \$177 million in FY02 to \$260 million in FY11. If the County issues General Obligation bonds at the rate projected in the most recent CIP (\$325 million/year), the cost of debt service will increase to \$391 million in FY16, a 50% increase from FY11. By FY16, debt service is projected to cost more than the combined tax supported budgets of the College and M-NCPPC.

C. TRENDS IN COSTS OF THE WORKFORCE (EMPLOYEE PAY AND BENEFITS)

1. **Personnel costs (pay and benefits) account for 82% of all tax supported spending. Between FY02 and FY11, personnel costs increased 64% while the total number of workyears increased 10%.** The workforces at all four agencies fluctuated during the past decade, but only MCPS and the College workforces are measurably larger today compared to ten years ago. Specifically, from FY02-FY11, MCPS' workyears increased 14% while MCPS enrollment increased 6%; Montgomery College's workyear growth of 30% paralleled the College's enrollment growth of 32%.

EXECUTIVE SUMMARY
PART I, REVENUE AND EXPENDITURE TRENDS IN MONTGOMERY COUNTY

2. **Between FY02 and FY11, the primary driver behind higher personnel costs was not an increase in the size of the workforce but rather the increase in average costs per employee.** Across the four agencies, employee salaries grew by 50% in the aggregate and by higher amounts (up to 80%) for individual employees, while the costs of health and retirement/pension benefits increased upwards of 120%. **In FY11, the combined agency cost of employee benefits is almost \$740 million, or 22% of all spending.** (This total would be higher had the agencies made FY11 payments to their OPEB trust funds.)
3. **Another way to track the rise in spending on employee benefits is to calculate their cost as a percent of salary.** As one example, for County Government, the aggregate cost of employee benefits as a percent of salary increased from 35% in FY02 to 52% in FY11. This means that for every \$1 the County spends on salary, it now pays 52 cents for benefits. The drivers behind these rising costs are the overall rise in health care costs, and major increases in annual pension/retirement plan contributions. Especially noteworthy is that during the past decade, the per employee cost of a defined benefit pension increased at more than twice the rate of a defined contribution retirement plan.

D. LOOKING FORWARD

1. **The balanced six-year Fiscal Plan adopted by the Council shows tax supported revenues (within the Charter limit) steadily increasing at about 3% per year.** Although these projections show FY16 tax supported revenue that is 16% higher than current year (FY11) revenue, it is important to recognize that the County's revenue is projected to grow at half the rate it did during the past decade.
2. **Looking ahead to FY12-FY16, the County's budget allocation decisions will increasingly be dominated by costs that are resistant to change.** The most striking trend contained in agency cost projections is the steady growth in the total costs of the County's legal and policy commitments, which by FY16 will sum to about \$1.6 billion, or about one-third of all available resources. The calculation of these commitments includes the costs of debt service, health insurance for active and retired employees, retirement/pension benefits, and contributions to the OPEB trust, PAYGO, and County fund reserves.

OLO concludes that the County faces a structural budget problem. The steadily rising costs of the County's legal and policy commitments, many of which are resistant to change, are projected to exceed the growth in anticipated revenues for the foreseeable future. The magnitude and recurring nature of these costs means that one-time solutions are insufficient to resolve the problem. In order to achieve long-term fiscal sustainability, the County must consider reforms that either raise more revenue or lower the projected cost curves associated with ongoing government operations and future promises.

E. OPTIONS FOR LONG-TERM FISCAL BALANCE

OLO's Part II report (scheduled for Council release on 12/7/10) will contain options for changes that could help achieve long-term fiscal balance in the County. The report will consist of a series of issue papers on the topics listed below. Part II will also contain some comparative information about reforms being considered by other state and local governments, and a County Attorney's opinion on the legal issues related to changing employee pay and benefits.

- | | |
|--|----------------------|
| • Salaries and wages | • Workforce size |
| • Pension/retirement benefits | • Operating expenses |
| • Health benefits for active employees | • Debt |
| • Health benefits for retirees | • Revenue |

EXECUTIVE SUMMARY

PART II, OPTIONS FOR LONG-TERM FISCAL BALANCE

This report is the second part of the Office of Legislative Oversight's two-part assignment on achieving a structurally balanced budget in Montgomery County.

As requested by the County Council, the purpose of Part II is to inform a discussion of options to help the County navigate toward long-term fiscal sustainability. As with the many other jurisdictions that face similar budget pressures, the County's fiscal picture for the foreseeable future requires decisions that will inevitably require some to pay more and others to receive less. Marginal, short-term, and one-time fixes will not produce a sustainable solution for the County.

The options outlined in OLO's Part II report offer an array of potential budget savings and revenue raising choices. Some would yield substantial savings in the short term, and others would yield even greater savings but only in the longer term. Many of the options are not mutually exclusive and could be combined to achieve some savings in the short term and more over time.

The cost containment and/or revenue raising options that the Council decides to consider will be influenced by some key information that is not yet in hand. This includes updated revenue projections, updated estimates of the County's pension and OPEB (retiree health trust) liabilities, and the agencies' and County Executive's future budget requests, which will reflect the collective bargaining agreements reached between the County Executive and the County Government unions and the Board of Education and the school unions.

The rest of this executive summary provides a general background and roadmap to the contents of OLO's Part II report, which consists of eight issue papers and an appendix of related information. This executive summary concludes with some recommended next steps for the Council's consideration of the report's contents.

BACKGROUND

OLO's Part I analysis concluded that Montgomery County faces a structural budget problem.¹ By FY16, the combined cost of the County's legal and policy commitments (i.e., employee pensions, health insurance for active and retired employees, debt service, and current revenue contributions to the capital budget, retiree health trust fund, and County's fund reserves) is projected to total \$1.6 billion, or roughly one-third of all available tax revenue.

In the current climate, revenue growth for the foreseeable future is unlikely to keep pace with the steadily rising costs of our public sector's spending commitments. Consequently, the approach of previous years - where projected revenue for the upcoming fiscal year was sufficient to fully fund the current year's budget, absorb the increased cost of commitments, and support new initiatives (e.g., program expansions, salary increases) - no longer works.

As a result, Montgomery County, like many other state and local governments across the nation, faces the extraordinary challenge of making decisions that will result in long-term fiscal sustainability, a task that can only be accomplished by permanently raising more revenue or making reforms that reduce future government costs.

¹ OLO's Part I findings, presented to the Montgomery County Council on 11/23/10, are available at: <http://www.montgomerycountymd.gov/content/council/olo/reports/pdf/2011-2.pdf>

WHAT GUIDED OLO'S SELECTION OF OPTIONS TO INCLUDE?

The options that OLO selected to examine flow directly from our Part I analysis, which identified the major cost drivers of the tax supported budgets for the four agencies: County Government, Montgomery County Public Schools, Montgomery College, and M-NCPPC.

In order to deliver a useful product to the Council, OLO selected a finite number of cost savings and revenue raising options to assess and present. The Appendix (©4) contains a list of additional options worthy of mention, any of which are potential candidates for further development.

OLO's selection of specific cost containment and budget reduction options is based on the following factors:

- 1. The experience of other jurisdictions.** The cost pressures and difficult trade-offs facing Montgomery County are by no means unique. OLO was guided by research into how other state and local governments are addressing their own structural revenue and expenditure imbalances. The Appendix (©119) contains examples of cost containment strategies for retirement benefits and health insurance costs undertaken in other places.
- 2. The advice of subject matter experts.** Throughout the study period, OLO's work was guided by the advice of subject matter experts, particularly on the technically complex issues of public sector finance and employee benefits. OLO consulted extensively with the many knowledgeable professionals in the agencies' respective budget, finance, and human resources offices. OLO also reviewed a plethora of articles, reports, and research briefs written in recent years about balancing public sector budgets and ongoing fiscal sustainability.
- 3. The potential for substantial and recurring agency savings.** OLO placed priority on options that, if implemented, could result in substantial and recurring reductions in tax supported agency costs. Because employee pay and benefits constitutes 82% of tax supported spending, this is where we concentrated our effort. The first five issue papers address options to reduce agency spending on the building blocks of personnel costs: employee salaries, retirement/pension benefits, health benefits for active employees, health benefits for retirees, and workforce size.
- 4. The legal feasibility of structural changes to employee pay and benefits.** Shortly after being assigned this project, OLO requested an opinion from the County Attorney on the legal issues related to changing employee pay and benefits. All of the options included in OLO's issue papers adhere to the guidance outlined in the memo from the County Attorney, which is included in its entirety in the Appendix (©8).
- 5. Reforms that would reduce per employee costs.** OLO's Part I analysis showed that the primary driver of agency personnel expenditure growth is not a larger workforce, but rather higher per employee costs. Based on this finding, the papers that deal with personnel cost issues focus on changes to the structure of employee salaries and benefits that either lower or reduce the growth rate of the agencies' per employee costs.

6. The need to address the issues of workforce size, but without duplicating work of the Organizational Reform Commission and Cross-Agency Resource-Sharing Committee. One way to lower personnel costs is to reduce the workforce. Concurrent to this OLO project, two efforts underway are expected to identify potential budget savings based on functional reorganizations or consolidations and increased efficiency of government operations. Specifically:

- The Organizational Reform Commission was established jointly by the Council and County Executive earlier this year. The Commission was created to make recommendations for potential reorganization or consolidation of functions performed by the County-funded agencies. The Commission was tasked with submitting a final report to the Council and Executive by January 31, 2011.
- The Cross-Agency Resource-Sharing Committee (CARS) is a major inter-agency effort launched earlier this year by the County Government's Chief Administrative Officer, for the stated purpose to provide a "forum among County agencies to share ideas/best practices, develop potential resource-sharing strategies to achieve operational efficiencies, reduce costs, and improve the quality of services offered to our residents." CARS is on schedule to submit its first round of recommendations to the CARS Executive Committee later this month.

The Appendix (©48-67) contains more information about both groups and the status of their work to date. In order to supplement and not duplicate the efforts of these two initiatives, OLO's issue paper on workforce size provides a macro-perspective on the number of positions (measured in workyears) that would need to be abolished in each agency in order to lower personnel costs, calculated in increments of \$10 million.

7. The role of debt service in the competition for tax supported revenue. OLO's Part I analysis highlighted the rising cost of debt service over the past ten years, and its projected growth going forward. Because dollars spent on paying back debt are not available to fund the annual agency operating costs, OLO includes several options that show how reducing debt issuance frees up more resources for agency operating budgets.

8. The inclusion of options to raise more revenues. While the bulk of OLO's Part II report provides options that would reduce spending, the final issue paper addresses options to raise more revenue. Should there be interest in seeking additional tax supported revenue to pay for existing spending commitments and emerging budget priorities, the choices are either to:

- Adjust the rates for current revenue sources; or
- Identify new revenue sources.

In selecting options for raising revenue, OLO included one for each of the major sources of local revenue: property tax, income tax, excise taxes, and user fees.

OVERVIEW OF THE EIGHT ISSUE PAPERS.

The next three pages contain brief overviews of the eight issue papers. Details on the sources of data and methodology used to calculate potential costs savings are included in the Appendix (©68).

OVERVIEW OF THE EIGHT ISSUE PAPERS

A. Employee Salaries

Salaries represent the largest component of personnel costs. Between FY02 and FY11, employee salaries across the four agencies grew by 50% in the aggregate and by higher amounts (up to 80%) for individual employees. Issue Paper A includes one approach that would actually reduce the total cost of salaries and a series of options to slow the rate of salary growth:

- The first option presents cost savings associated with three different levels of an across-the-board salary rollback (1%, 3%, and 5%) for all agency employees. A salary rollback is a permanent reduction in an employee's base salary. A 1% salary rollback implemented in FY12 across the four agencies would save about \$23 million.
- The other salary-related options explore a range of alternatives for modifying the current structure of general wage adjustments and step increases. Modifying the structure of pay increases could substantially lower the growth rate of personnel costs going forward, compared to their growth rates over the past decade.

B. Retirement/Pension Benefits

From FY02 to FY11, tax supported costs of pension and retirement benefits for employees across the four agencies increased by 226%, from \$59 million to \$193 million. By FY16, annual agency retirement costs are projected to cost more than \$264 million. (This estimated amount does not include any costs related to a potential shift of pension liability from the State to the County for MCPS, Montgomery College, and library employees.)

Issue Paper B presents options to lower the projected increases in locally paid annual pension and retirement benefit costs for County Government and MCPS, including approaches to:

- Replace defined benefit retirement plans with lower cost defined contribution or hybrid plans;
- Increase the share of retirement costs paid by employees; and
- Reduce benefit levels.

Changes to retirement/pension plans hold the potential for saving hundreds of millions of dollars in the long-term. However, if changes are restricted to new hires, the savings will not be large in the immediate term. Actuarial analysis is necessary to determine the specific dollar savings that is achievable for any options related to retirement benefit changes.

C. Health Benefits for Active Employees

Over the past decade, total tax supported agency spending on group insurance (primarily health insurance and prescription drug coverage) for active employees increased 134%, from \$134 million to \$315 million. The costs of group insurance (assuming no change to the current structure) are estimated to increase another 55% to \$487 million by FY16.

Issue Paper C presents options to reduce the cost of health benefits through restructuring how the premium is split between the employer and the employee. Specific options included are to:

- Set a uniform employer cost share of 70% for all plans;
- Charge employees who enroll dependents a higher cost share; and
- Set a uniform employer cost share of 60% for part-time employees.

Implementing the options outlined in this paper (as of January 2012) could produce savings for the four agencies that range from \$7 million to \$46 million in FY12, and from \$19 million to \$123 million by FY16. Phasing in changes over several years also provides cost savings, but at a slower rate.

D. Health Benefits for Retirees

Over the past ten years, total pay-as-you-go agency spending on group insurance for retired employees more than doubled from \$31 million to \$79 million. Absent changes to the current structure, these costs are estimated to increase another 57% to nearly \$124 million by FY16. According to the latest actuarial estimates, the County's total future liability for retiree group insurance costs is estimated at \$2.7 billion.

Issue Paper D presents options to lower the projected increases in agency retiree health insurance by:

- Eliminating retiree group insurance benefits for new employees;
- Reducing the employer's share of premium costs; or
- Changing current eligibility criteria and/or benefit levels for retiree health insurance.

Actuarial analysis is necessary to determine the potential savings that could be achieved by implementing any of these options. Changing the structure of retiree health benefits holds the potential to save tens of millions of dollars every year; however, if the changes are only applied to new hires, then the savings in the near term will be relatively modest.

E. Workforce Size

OLO's Part I analysis found that the primary cost driver behind increased personnel costs over the past decade has been higher costs per employee as opposed to substantial growth in the workforce. Nonetheless, reducing positions, measured in workyears, represents one way to reduce personnel costs.

The content of the issue paper on workforce size was designed to supplement and not duplicate the work of the Organizational Reform Commission and Cross-Agency Resource-Sharing Committee. Both of these groups have been tasked with recommending potential budget savings that would result from functional reorganizations/consolidations and increased efficiency of government operations.

Issue Paper E provides an overview of the allocation of workyears across the agencies, and calculates the number of workyears (for each agency) that must be eliminated in order to yield increments of \$10 million in savings. To provide some additional perspective, Issue Paper E also includes illustrative examples of what \$10 million in workyears "buys" in each agency.

F. Operating Expenses

"Operating expenses" consist of everything in an agency's operating budget other than personnel costs. Examples include spending for contractual support, utility payments, facility and vehicle maintenance, office and program supplies, and technology. In FY11, budgeted operating expenses represent about 9% of MCPS' tax supported spending and 32% of County Government's tax supported spending.

Issue Paper F summarizes the major components of tax supported operating expenses for County Government and Montgomery County Public Schools, and discusses two approaches to reduce FY12 operating costs in order to achieve increments of \$10 million in savings. One approach is an "across-the-board" reduction that decreases operating expenses in all departments by a uniform percent. Another approach is for targeted reductions in operating expenses using priority-based criteria.

G. Debt Service

During the past decade, debt service payments increased 47% from \$177 million in FY02 to \$260 million in FY11. If the County issues General Obligation bonds at the rate projected in the most recent CIP (\$325 million/year), debt service will increase to \$391 million in FY16, an amount that is projected to exceed the combined tax supported budgets of Montgomery College and M-NCPPC.

Issue Paper G calculates the projected savings in annual debt service that would result from reducing annual general obligation bond issuance. In addition, this paper identifies the potential consequences of reducing the amount of debt issued.

H. Revenue

Issue Paper H presents four options to generate additional revenue for tax supported expenditures. One option is presented for each of the major locally generated sources of revenue:

- Property taxes,
- Income taxes,
- Excise taxes, and
- Fees/charges.

Three of the four options would generate revenue that would be available for unrestricted use. The fourth option would raise revenue for transportation projects that add new capacity. The paper provides estimates of potential additional revenue associated with each option, which ranges from \$3-\$20 million in FY12 to more than \$150 million by FY16.

Appendix

The Appendix contains additional background and reference materials, including:

- A primer on the State's Maintenance of Effort law;
- Memoranda from the County Attorney on the Council's authority to modify employee salaries and benefits, and the Council's role in collective bargaining;
- Regional comparative data on health and retirement benefits; and
- Case studies of changes to employee retirement and health benefits in other jurisdictions across the country.

In addition, the Appendix includes a glossary of terms, copies of Council resolutions related to fiscal and debt policies, and additional information on the charges and work to date of the Organizational Reform Commission and the Cross-Agency Resource-Sharing Committee.

RECOMMENDED NEXT STEPS

County leaders face a large and complex challenge of bringing projected revenue and spending into long-term alignment. To assist in this effort, the Council requested the Office of Legislative Oversight to develop options that can form the basis for an informed discussion about various ways to raise revenue and/or bend the agencies' future cost curves downward.

As stated earlier, the number and choice of specific cost containment and/or revenue raising options that the Council will need to consider will depend, at least in part, on some key information that is not yet in hand. This includes: updated revenue projections, updated estimates of the County's pension and OPEB (retiree health trust) liabilities, and the agencies' and County Executive's future budget requests, which will reflect the collective bargaining agreements reached between the County Executive and the County Government unions and the Board of Education and the school unions.

Although the exact size of the FY12 and future year structural budget "gaps" that the Council needs to close is not yet known, OLO recommends that the Council prepare for the upcoming budget deliberations by adopting an explicit time line for discussion of this Part II report that includes the following steps:

1. An initial period designated for the Council to ask questions and for staff to prepare answers, with the overall purpose of enabling a common understanding of the options presented.
2. A step for seeking feedback from the general public as well as known stakeholders. The Council should consider coordinating the timing of such input with any outreach efforts that the Council holds on the recommendations of the Organizational Reform Commission and the Cross-Agency Resource-Sharing Committee.
3. A date by which the Council selects a short list of options for further research and analysis that might involve, for example, more refined estimates of cost savings, more detailed analysis of the potential impact on employees, a proposed implementation schedule, and the gathering of more specific comparative data. Included in this step would be any Council requests for additional legal advice or cost estimates related to options that require retaining actuarial services.
4. A decision and action phase, during which the Council decides which, if any, of the options to support, and then takes the legislative, policy, and/or budget actions necessary to move forward with implementation.

As the Council works its way through this next phase of gathering more information, soliciting feedback, weighing alternatives, and making decisions, OLO offers some closing observations on key facts to keep in mind:

- Government is a people-intensive business, so it is no surprise that the great majority of the County's resources is allocated to human capital. Unfortunately, the corollary to this reality is that achieving substantial budget savings requires the County to reduce spending on personnel. There are two ways to reduce personnel costs: shrink the workforce and/or lower costs per employee.
- The County Government and Montgomery County Public Schools (MCPS) together account for 91% of all tax supported spending. MCPS accounts for two-thirds of all tax supported workyears. In order to yield substantial savings, any cost containment option that involves reducing personnel costs must extend to both County Government and MCPS.

- Structural changes to pay or benefits that reduce per employee costs but only apply to newly hired employees will not yield large savings in the near term. There are some options, however, such as changing the structure of pension benefits and retiree health benefits, that hold the potential for substantial dollar savings in the longer term even if only applied to new hires.

For the many governments currently struggling to align revenues and desired expenditures, it certainly would be desirable if some options existed that magically provided win-win solutions. However, as with so many other jurisdictions, the reality of the County's fiscal picture, at least for the foreseeable future, requires decisions that involve asking some to pay more and/or others to make do with less. In other words, the reality is that none of the options promise an outcome where everyone wins.

Montgomery County Council
Office of Legislative Oversight

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The Office of Legislative Oversight appreciates the cooperation received from the leadership and staff of the County Government, Montgomery County Public Schools, Montgomery College, and Maryland-National Capital Park and Planning Commission. This assignment was a major undertaking during a compressed time period. OLO's work was greatly facilitated by the reliable and constructive assistance of the four agencies involved. Special thanks are also owed to the Council Staff Director and the many other Council staff members with whom we consulted regularly.

Resolution No:	<u>16-1415</u>
Introduced:	<u>May 27, 2010</u>
Adopted:	<u>June 29, 2010</u>

**COUNTY COUNCIL
FOR MONTGOMERY COUNTY, MARYLAND**

By: Council President at the Request of the County Executive

SUBJECT: Reserve and Selected Fiscal Policies

Background

1. Fiscal policy corresponds to the combined practices of government with respect to revenues, expenditures, debt management, and reserves.
2. Fiscal policies provide guidance for good public practice in the planning of expenditures, revenues, and funding arrangements for public services. They provide a framework within which budget, tax, and fee decisions should be made. Fiscal policies provide guidance toward a balance between program expenditure requirements and available sources of revenue to fund them.
3. As a best practice, governments must maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Fund balance levels are a crucial consideration, too, in long-term financial planning. Credit rating agencies monitor levels of fund balance and unrestricted fund balance in a government's general fund to evaluate a government's continued creditworthiness.
4. In FY10, the County experienced an unprecedented \$265 million decline in income tax revenues, and weathered extraordinary expenditure requirements associated with the H1N1 flu virus and successive and historic winter blizzards. The costs of these events totaled in excess of \$60 million, only a portion of which was budgeted and planned for.
5. In a memorandum dated April 22, 2010, the County Executive recommended that the County Council restore reserves first to the current 6% policy level for FY11 and also to revise and strengthen policy levels in order to more appropriately position the County to weather economic cycles in the future, and to achieve structural balance in future budgets.
6. The County's financial advisor has recommended that the County strengthen its policy on reserves and other fiscal policies to ensure budget flexibility and structural stability, and has provided specific recommendations, which are reflected below.

Action

The County Council for Montgomery County, Maryland, approves the following policies regarding reserves and other fiscal matters:

1. Structurally Balanced Budget

Montgomery County must have a goal of a structurally balanced budget. Budgeted expenditures should not exceed projected recurring revenues plus recurring net transfers in minus the mandatory contribution to the required reserve for that fiscal year. Recurring revenues should fund recurring expenses. No deficit may be planned or incurred.

2. Reserves

Montgomery County must have a goal of achieving the Charter §310 maximum for the reserve in the General Fund of 5% of General Fund revenues in the preceding fiscal year, and of building up and maintaining the sum of Unrestricted General Fund Balance and Revenue Stabilization Fund Balance to 10% of Adjusted Governmental Fund revenues, as defined in the Revenue Stabilization Fund law. This goal must be reflected in the Revenue Stabilization Fund law.

3. Use of One-Time Revenues

One-time revenues and revenues in excess of projections must be applied first to restoring reserves to policy levels or as required by law. If the County determines that reserves have been fully funded, then one-time revenues should be applied to non-recurring expenditures which are one-time in nature, PAYGO for the CIP in excess of the County's targeted goal, or to unfunded liabilities. Priority consideration should be given to unfunded liabilities for Retiree Health Benefits (OPEB) and Pension Benefits Prefunding.

4. PAYGO

The County should allocate to the CIP each fiscal year as PAYGO at least ten percent of the amount of general obligation bonds planned for issue that year.

5. Fiscal Plan

The County should adopt a fiscal plan that is structurally balanced, and that limits expenditures and other uses of resources to annually available revenues. The fiscal plan should also separately display reserves at policy levels, including additions to reserves to reach policy level goals.

6. Reports to Council

The Executive must report to the Council:

- a. the prior year reserve and the current year reserve projection as part of the November fiscal plan update;*
- b. current and projected reserve balance in the Executive's Annual Recommended Operating Budget;*
- c. any material changes expected to have a permanent impact on ending reserve fund balance; and*
- d. current and projected reserve balances in any proposed mid-year savings plan.*

This is a correct copy of Council action.



Mary Anne Paradise, Acting Clerk of the Council

Table 1. Summary of Options Related to Pay and Benefits (all agencies)

Option	Potential FY12 Savings	Estimated Savings Amount (\$ in millions)				
		FY12	FY13	FY14	FY15	FY16
Workforce size						
Reduce the size of the current workforce in one or more agency	✓	Depends on number and type of positions abolished; would need to abolish between 89-153 workyears for each \$10M in savings.				
Employee Salaries (assumes implementation across all four agencies in FY12)						
#1A: 1% Salary Rollback in FY12	✓	\$22.9	\$22.9	\$22.9	\$22.9	\$22.9
#1B: 3% Salary Rollback in FY12	✓	\$68.7	\$68.7	\$68.7	\$68.7	\$68.7
#1C: 5% Salary Rollback in FY12	✓	\$114.6	\$114.6	\$114.6	\$114.6	\$114.6
#2: Changes to GWA		Could lower rate of increase going forward				
#3: Changes to Step Increases						
Health Benefits for Active Employees (assumes implementation across all four agencies and includes non-tax supported savings)						
#1A: Change premium cost share to a 70/30 split, All-at-once	✓	\$35.2	\$73.4	\$79.8	\$86.8	\$94.4
#1B: Change premium cost share to a 70/30 split, 5% phase-in	✓	\$9.7	\$30.4	\$51.2	\$71.7	\$90.4
#2: Change to fixed employer contribution at 75% of lowest cost plan	✓	\$46.0	\$96.0	\$104.2	\$113.2	\$122.9
#3: Higher cost share for self+1 (by 2.5%) and family (by 5%) coverage	✓	\$7.2	\$14.9	\$16.3	\$17.7	\$19.2
#4: Higher premium cost share (60/40) for part-time employees	✓	\$12.2	\$25.5	\$27.7	\$30.1	\$32.7
Retirement/Pension Benefits (all options require actuarial analysis)						
MCG #3: Increase employee contributions to defined benefit plans	✓	FY12 savings if applied to <u>current employees</u>				
MCG #5: Lower the pension COLA cap	✓	FY12 savings if applied to <u>current retirees</u>				
MCG #1: Enroll all new MCG employees in defined contribution plan		Could provide significant long-term savings				
MCG #2: New hybrid plan for new public safety employees						
MCG #4: Increase retirement eligibility criteria for new public safety employees						
MCPS #3: Increase MCPS employee contributions to pension supplement	✓	FY12 savings if applied to <u>current employees</u>				
MCPS #1: Create a defined contribution plan for local-funded retirement benefits		Could provide significant long-term savings				
MCPS #2: Eliminate MCPS' local pension supplement						
MCPS #4: Integrate local-funded MCPS pensions with Social Security						
Health Benefits for Retired Employees (all options require actuarial analysis)						
#2: Change premium cost sharing arrangements	✓	FY12 savings if applied to <u>current retirees</u>				
#1: Eliminate retiree health benefits for new hires		Could provide significant long-term savings				
#3: Change eligibility criteria and/or benefit levels						

Table 2. Summary of Operating Expenses and Debt Service Options

Option	Potential FY12 Savings	Estimated Savings Amount (\$ in millions)				
		FY12	FY13	FY14	FY15	FY16
Operating Expenses						
Reduce operating expenses through an “across-the-board” reduction or a targeted reduction using priority-based criteria	✓	<ul style="list-style-type: none">• Depends on amount and type of reduction.• In County Government, a 2.7% reduction in total operating expenses would be required for each \$10 million in savings.• In MCPS, a 5.6% reduction in total operating expenses would be required for each \$10 million in savings.				
Debt Service						
#1A: 25% reduction to bond issuance limit	✓	\$2	\$11	\$19	\$27	\$35
#1B: 50% reduction to bond issuance limit	✓	\$4	\$22	\$38	\$54	\$70

Table 3. Summary of Revenue Options

Option	Potential FY12 Revenue	Estimated Revenue Amount (\$ in millions)				
		FY12	FY13	FY14	FY15	FY16
Revenue						
#1: Override Charter limit on property tax rate (by 1 cent per \$100 in assessed value)	✓	\$17.9	\$18.8	\$19.7	\$21.1	\$22.7
#2A: Reduce municipal income tax distributions by 50% over 5 years	✓	\$3	\$6	\$9	\$12	\$15
#2B: Reduce municipal income tax distributions by 100% over 5 years	✓	\$6	\$12	\$18	\$24	\$30
#3A: Continue FY11 Energy Tax rates		--	\$108	\$108	\$108	\$108
#3B: Continue allocation of recordation taxes to the General Fund	✓	\$13	\$13	\$13	\$13	\$13
#4: Enact Transportation utility charge	✓	Depends on structure of charge				

Table 4. Examples of What \$10 Million in Workyears Represents
(all examples based on the average cost per workyear data for each agency)

\$10 Million in Personnel Costs Pays for...	Which Represents...
County Government	
89 Public Safety Workyears	<ul style="list-style-type: none"> • 100% of career firefighters assigned to the following stations combined: Silver Spring #1, Kensington #18, and Gaithersburg #28
	<ul style="list-style-type: none"> • 69% of the police officers serving the Rockville District
	<ul style="list-style-type: none"> • 66% of the police officers in both the Criminal and Special Investigations Divisions
	<ul style="list-style-type: none"> • 60% of all uniformed sheriff officers
	<ul style="list-style-type: none"> • 30% of all uniformed correctional officers
109 Non-Public Safety Workyears	<ul style="list-style-type: none"> • 100% of staff in the following libraries combined: Aspen Hill, Chevy Chase, Germantown, Kensington Park, Little Falls, Long Branch, Poolesville, Quince Orchard, Twinbrook, Wheaton, and White Oak
	<ul style="list-style-type: none"> • 100% of staff in the Department of Technology Services
	<ul style="list-style-type: none"> • 100% of staff in the following departments/offices combined: Department of Economic Development, the Office of Consumer Protection, the Office of Human Resources, the Office of Management and Budget, the Regional Services Centers, and the Office of Legislative Oversight
	<ul style="list-style-type: none"> • 90% of staff in the State's Attorney's Office
	<ul style="list-style-type: none"> • 70% of staff in DHHS' Aging and Disability Services
MCPS	
153 Teacher "New Hire" Workyears	<ul style="list-style-type: none"> • 100% of all elementary and middle school staff development teachers
	<ul style="list-style-type: none"> • 100% of high school staff development, vocational education, vocational support, career preparation, academic intervention, and special program teacher positions combined
	<ul style="list-style-type: none"> • 85% of elementary music teachers
	<ul style="list-style-type: none"> • 8% of high school instruction teacher positions
	<ul style="list-style-type: none"> • Increase in average elementary and middle school class sizes by 1 student
114 Agency Workyears	<ul style="list-style-type: none"> • 100% of Assistant Principal positions
	<ul style="list-style-type: none"> • 95% of school- and central office-based positions for Enriched and Innovative programs (e.g., magnet and signature programs)
	<ul style="list-style-type: none"> • 88% of technology support positions
	<ul style="list-style-type: none"> • 51% of elementary school Instructional Media Center positions
	<ul style="list-style-type: none"> • 25% of school counselor positions at all levels
Montgomery College	
127 Agency Workyears	<ul style="list-style-type: none"> • 80% all staff at the Germantown campus
	<ul style="list-style-type: none"> • 56% of all staff at the Takoma Park campus
	<ul style="list-style-type: none"> • 26% of all staff at the Rockville campus
	<ul style="list-style-type: none"> • 25% of all Instructional Faculty across all three campuses
M-NCPPC	
119 Agency Workyears	<ul style="list-style-type: none"> • 100% of Parks Department Park Police Division staff
	<ul style="list-style-type: none"> • 100% of the combined staff of the Parks Department Central Maintenance and Facilities Management Divisions
	<ul style="list-style-type: none"> • 83% of all Planning Department staff
	<ul style="list-style-type: none"> • 17% of all Parks Department staff